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WILLIAM T FUJIOKA
Chief Executive Officer

December 31, 2007

To: Supervisor Yvonne B. Burke, Chair
Supervisor Gloria Molina
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From: for William T Fujioka
Chief Executive Officer

SACRAMENTO UPDATE

FY 2007-08 State Budget Fiscal Emergency

On December 21, 2007, Governor Schwarzenegger announced that he will issue a proclamation declaring a fiscal emergency and calling a special session of the Legislature to address the estimated $3.3 billion current-year budget shortfall. According to the Governor, the deficit is primarily attributable to: reduced revenues associated with the slump in the housing market, the sub-prime mortgage collapse, lower property tax revenue estimates and the decline in the economy, legal challenges which have delayed implementation of Indian gaming agreements, increased costs related to the recent wildfires, and an appellate court decision regarding teachers' retirement funding. The proclamation will be issued on January 10, 2008 concurrently with the release of the Governor's Proposed Budget for FY 2008-09 which, absent corrective action, is projected to include a deficit of over $14 billion.

Proposition 58

The Governor's authority to declare a fiscal emergency and call for a special session of the Legislature is allowed under Proposition 58, the California Balanced Budget Act, which was approved by the voters in March 2004. Once called into the special session, the Legislature must enact legislation within 45 days to address the fiscal emergency, or it will be prohibited from acting on any other bills or adjourning in joint recess until such legislation is passed.

Proposition 58 also requires the State to establish a special reserve called the Budget Stabilization Account (BSA). The Proposition requires annual transfers to be made from the State General Fund to the BSA totaling 1 percent of revenues in FY 2006-07, 2 percent in FY 2007-08, and 3 percent in FY 2008-09. One-half of the annual transfers are allocated to make payments on the outstanding deficit-financing bonds, as required by Proposition 57, the Economic Recovery Bond Act, while the other one-half is held in reserve and may be transferred to the State General Fund by a majority vote of the Legislature for various purposes. Use of these funds to address budget shortfalls, however, requires a two-thirds vote. In addition, the Governor has the authority to suspend the annual transfer through an executive order issued by June 1 of the preceding fiscal year.

In the Legislative Analyst's Office (LAO) Fiscal Outlook for FY 2007-08 through FY 2012-14, the LAO noted that it expects the Legislature to transfer the entire amount of the current BSA reserve balance, $1 billion from FY 2007-08, plus $472 million carried over from FY 2006-07, back to the State General Fund to address the current-year budget shortfall. Approximately $3.1 billion must be transferred to the BSA for FY 2008-09. The Legislature may redirect one-half of the BSA transfer to the State General Fund to address the budget deficit. If the Governor opts to suspend the entire transfer to the BSA, the total $3.1 billion would be available for budget use.

It is important to note that Proposition 58 and its companion measure, Proposition 57 which authorized the issuance of up to $15 billion in deficit bonds, limit the Legislature's options for addressing budget deficits through borrowing. The propositions prohibit the use of general obligation bonds, revenue bonds, and certain types of long-term borrowing to cover budget deficits. The restriction does not apply to short-term borrowing or borrowing between State funds.

Addressing the Budget Deficit Through Funding Shifts and Suspensions

Details of the Governor's plans to address the budget shortfall will not be known until January 10, 2008; however, the Governor and the Legislature will face a very difficult task to solve the budget deficit because their ability to shift local government revenues and transportation funds to the State General Fund is severely limited as a result of recent voter-approved initiatives. Suspension of the Proposition 98 minimum funding guarantee for K-14 education is another option to address the deficit

In November 2004, voters approved Proposition 1A, the Protection of Local Government Revenues Act. This measure provides constitutional protection of local revenue and services as they existed on November 3, 2004. However, effective FY 2008-09, Proposition 1A allows the State to borrow no more than

8 percent of the total amount of property tax revenues allocated among all local agencies within a county upon the declaration of a severe fiscal hardship. Borrowing of these funds can only take place twice in a 10-year period and only if the State has fully repaid any prior loans. We estimate that approximately $208 million in County revenue would be at risk in FY 2008-09 if the Governor and the Legislature enact the borrowing provisions allowed under Proposition 1A.

A shift of transportation funds is limited under Proposition 1A of 2006, the Transportation Funding Protection Act, which was approved by voters in November 2006. This measure requires the Governor to declare that a suspension of Proposition 42 is necessary due to "a severe State fiscal hardship." The suspension requires approval by a two-thirds vote of the Legislature and enactment of legislation to repay the funds, with interest, within three years. Proposition 1A of 2006 also limits Proposition 42 suspensions to two fiscal years over a ten-year period and prohibits any future suspensions unless prior suspensions are fully repaid. The estimated County impact in FY 2008-09 if the State suspends Proposition 42 funds is $61.0 million.

In the FY 2007-08 State Budget Act, Proposition 98 funding accounts for approximately 56 percent of the total State General Fund expenditures. Under Proposition 98, the Legislature has the authority to suspend the minimum funding guarantee for K-14 education with a two-thirds vote of the Legislature. The suspension allows the Legislature to appropriate funding for K-14 education at whatever level it chooses thus freeing up State General Fund monies. However, the suspension would create a maintenance factor which must be restored in future years, and would commit a significant portion of future General Fund revenue growth to restore education funding. The Legislature last suspended the Proposition 98 guarantee to address the FY 2004-05 budget shortfall.

We will continue to keep you advised.

WTF:GK:MAL
MR:VE:lm

c: All Department Heads
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